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No. 71-952

In the Supreme Court of the United States

OCTOBER TERM, 1971

LAEL KOLTUN, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 3-17) is reported at 54 T.C. 331. The opinion of the court of appeals (Pet. App. 1-2) is reported at 448 F. 2d 1268.

JURISDICTION

The judgment of the court of appeals was entered on September 3, 1971. By order dated November 24, 1971, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including January 31, 1972. The petition was filed on January 25, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

458-852—72

QUESTIONS PRESENTED

1. Whether both courts below correctly held that petitioners were not entitled to deduct amounts claimed as "interest" paid on "indebtedness" under Section 163 of the Internal Revenue Code of 1954, because no valid indebtedness existed.

2. Whether the courts below also correctly rejected petitioners' alternative contention that the evidence supported a deduction of the amounts as ordinary and necessary business expenses under Section 162.

STATUTES INVOLVED

The pertinent provisions of Sections 162 and 163 of the Internal Revenue Code of 1954 are set forth in the petition (pp. 2-3).

STATEMENT

Petitioners were limited partners in S.C. Investments, Ltd. (S.C.I.), a partnership that was in turn a limited partner in Lake Murray Apartments (Lake Murray). The other partner in Lake Murray was Sunset International Petroleum Corporation (Sunset), a publicly held corporation engaged in, among other things, real estate development projects. On August 12, 1963, Lake Murray entered into an agreement with Sunset under which Sunset was to construct an apartment project on Lake Murray's property for a price in excess of $3 million. Sunset agreed to "provide and/or procure" financing for Lake Murray in the amount of $3,170,000. Lake Murray agreed that in consideration for the financing it would pay Sunset $63,000 as a "loan fee" as well as $221,812.50 as "prepaid interest." Sunset agreed to begin construction on

or before December 10, 1963. (Pet. App. 4, 5-6, 7-12, 13.)

Sunset did not begin construction in accordance with the agreement, and the apartments were never constructed. Neither was it ever able to provide or procure the promised financing. Nevertheless, on December 19 and 24, 1963, Lake Murray turned over a total of $300,000 (a sum borrowed from S.C. sufficient to cover the "prepaid interest" and "clean fee") to Sunset. That money was deposited by Sunset in its project bank account and credited on Sunset's books to the Lake Murray intercompany account. Sunset did not report that sum as income on its original income tax return for 1963. Subsequently, the Internal Revenue Service audited Lake Murray. At that point, Sunset made a journal entry transferring $284,812.50 from the intercompany account to a prepaid interest account and filed an amended return including that amount as income.[2] (Pet. App. 12-14.)

On its partnership return for 1963, Lake Murray deducted the $284,812.50 as interest paid to Sunset. The Commissioner disallowed the partnership's deduction and hence the taxable portion claimed by each of the partners, resulting in the deficiencies herein. (Pet.

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[1] It was contemplated that the financing would be obtained or provided by December 1963. The "clean fee" and "prepaid interest" were to be paid by December 6, 1963. The "prepaid interest" was computed on the basis of a 13-month construction period with construction to begin no later than December 10, 1963. (Pet. App. 9, 13.)

[2] Sunset had net operating losses available to it in excess of the amount included in income (Pet. App. 11).

App. 3–5.) The Tax Court sustained the Commissioner's determination (Pet. App. 3–17), and the court of appeals affirmed *per curiam* (Pet. App. 1–2).

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other ground for further review.

1. Section 163(a) of the Internal Revenue Code of 1954 permits a deduction from taxable income for "all interest paid or accrued within the taxable year on indebtedness." The phrase "interest * * * on indebtedness" has a well recognized meaning defined by this Court as "compensation for the use or forbearance of money." *Deputy* v. *DuPont*, 308 U.S. 488, 498; see also *Old Colony Railroad Co.* v. *Commissioner*, 284 U.S. 552, 560. Equally well settled is the definition of "indebtedness" as "an existing, unconditional, and legally enforceable obligation for the payment of money." *First National Co.* v. *Commissioner*, 289 F. 2d 861, 865 (C.A. 6). It follows that a taxpayer claiming a deduction for interest must prove, *inter alia*, that a valid debt actually existed. Treasury Regulations on Income Tax (1954 Code), § 1.163–1(a) (26 C.F.R.); *Autenreith* v. *Commissioner*, 115 F. 2d 856 (C.A. 3); *Gilman* v. *Commissioner*, 53 F. 2d 47 (C.A. 8).

Petitioners have not made the requisite showing. The agreement of August 12, 1963, which was never honored by Sunset, did not evidence a valid, unconditional indebtedness on the part of Lake Murray. Rather than creating an indebtedness, it merely reflected a promise by Sunset to make a loan *in futuro* which was not kept. Indeed, when Lake Murray chose

to turn over the $300,000 to Sunset on December 19 and 24, 1963, no financing had been obtained, and it was apparent that Sunset had defaulted on its part of the bargain. In short, Lake Murray was never obligated to repay Sunset funds that it had never received, and was never indebted to Sunset or anyone else for $3,150,000. It accordingly had no right to a deduction for "interest * * * on indebtedness."

2. Petitioners alternatively argue (Pet. 15–16) that they are entitled to deduct the $284,812.50 as ordinary and necessary business expenses under Section 162. But the Tax Court found (Pet. App. 17) that this argument had not been properly raised and, in any event, that the evidence introduced at trial failed to establish that the various requirements of a trade or business deduction (see *Commissioner* v. *Lincoln Savings and Loan Assn.*, 403 U.S. 345, 352) had been satisfied. Neither of these determinations warrants review by this Court.

Since there was no indebtedness to support the deduction of interest, the argument that the $63,000 "loan fee" was interest is likewise unavailing. Moreover, even if there had been an indebtedness, the nature of the proposed $63,000 "loan fee" was not such as to qualify it as a payment made in compensation for the use or forbearance of money. The contract describes the fee as being "[i]n consideration of the obtaining and or providing of said interim financing" (Pet. App. 81), *i.e.*, in the nature of a payment for services rendered rather than compensation for the use or forbearance of money. Such a payment is not deductible as interest. See Rev. Rul. 69-188, 1969-1 Cum. Bull. 54.